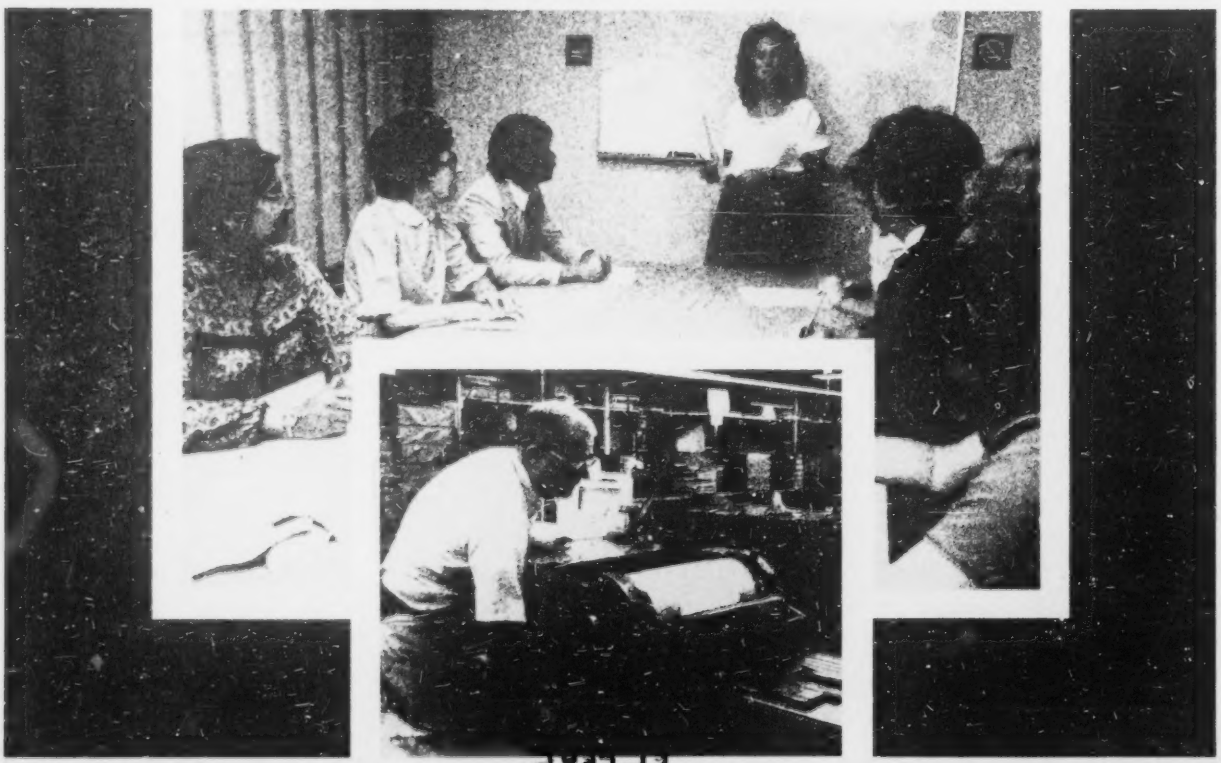
CONGRESS OF THE UNITED STATES
CONGRESSIONAL BUDGET OFFICE

JUNE 1987

Contracting Out: Potential for Reducing Federal Costs



J132-13

A SPECIAL STUDY

CONTRACTING OUT: POTENTIAL FOR REDUCING FEDERAL COSTS

The Congress of the United States
Congressional Budget Office

NOTES

Unless otherwise indicated, all years referred to in this report are fiscal years.

Details in the text and tables of this report may not add to totals because of rounding.

PREFACE

In its Circular A-76, the Office of Management and Budget directs agencies to procure support services from private firms. The practice has strong proponents and detractors. The Administration would like to see the use of private firms expanded, believing it provides a way of reducing federal costs without cuts in service levels.

This study, undertaken at the request of Senator Humphrey, former chairman of the Senate Armed Services Subcommittee on Preparedness, provides background on the A-76 program and the questions surrounding it. It also estimates the cost reductions possible under the current program and several alternative approaches. The report updates the Congressional Budget Office's (CBO's) 1982 report on the same subject, incorporating knowledge gained from the significant federal experience with A-76 that has accumulated since that time. In keeping with CBO's mandate, no recommendations are made.

R. Mark Musell of the General Government Management staff of CBO's Office of Intergovernmental Relations prepared the paper under the supervision of Stanley L. Greigg and Earl Armbrust. The author gratefully acknowledges the contribution of Daniel W. Coffey, who provided data processing support. Many individuals provided advice, information, and comments, and the author would especially like to acknowledge the assistance of staff members at the Department of Defense and the Office of Management and Budget. Paul L. Houts edited the manuscript. Mary V. Braxton typed the many drafts and prepared the report for publication.

Edward M. Gramlich
Acting Director

June 1987

CONTENTS

	SUMMARY	vii
I	INTRODUCTION	1
	The A-76 Program: How Decisions are Made *2* Current Service Contracting *6* Potential for Additional Contracting Out *8* The Debate on Contracting Out *10*	
II	COST REDUCTIONS UNDER THE CURRENT PROGRAM	15
	CBO's Estimating Procedures and Basic Assumptions *15* Potential Cost Reductions Under the A-76 Program *17*	
III	OPTIONS FOR THE GOVERNMENT'S CONTRACTING OUT PROGRAM	21
	Options for Potential Cost Reduction *21*	
APPENDIX	ESTIMATING POTENTIAL COST REDUCTIONS FOR THE A-76 PROGRAM	27

TABLES

S-1.	Average Annual Cost and Job Reductions from Options for the A-76 Program, 1988-1992	x
1.	Service Contract Awards 1983-1985	7
2.	Reductions in Accrual Costs from One Year's A-76 Activity Under Current Levels of Effort	18
3.	Annual Cash Savings from One Year's A-76 Activity Under Current Levels of Effort	19
4.	Cumulative Cash Savings Under Current Levels of Effort, 1988-1992	20
5.	Average Annual Cost and Job Reductions from Options for the A-76 Program, 1988-1992	23
A-1.	A Comparison of CBO Estimating Factors and DoD Data	30

SUMMARY

The government can often reduce costs by obtaining data processing, maintenance, and other commercial-type support services from private firms under contract instead of doing the work in-house using federal employees. The practice of contracting out, however, is controversial. Advocates point to the potential savings, noting also that private markets are strengthened when the government refrains from performing commercial activities itself. Opponents focus on the lower quality of services that contractors may provide and on the loss of federal jobs. Others question just how much contracting out actually reduces federal costs. Some managers complain that contracting out limits their control and makes establishing accountability difficult.

Over the last three years, contracts awarded for commercial-type services have increased by about 10 percent--from $32.8 billion in 1983 to $36.0 billion in 1985 (measured in 1983 dollars). Considerable room remains, however, for expansion. For example, Department of Defense (DoD) inventory data for 1985 show the equivalent of about 105,000 full-time civilian jobs in activities that could eventually be considered for contracting out. Federal regulations and provisions of certain statutes exempt another 275,000 jobs from private-sector operation. Although agency inventories do not yet cover all of the commercial activity in government, even under current levels of effort, activities already in inventories could keep agency contracting out programs busy for many years.

CURRENT POLICY AND THE ADMINISTRATION'S STANCE

In view of recent budgetary constraints, interest in the savings potential of contracting out has grown. The present administration has promoted it as a method of lowering federal costs without cutting services. Executive Branch policy, detailed in Office of Management and Budget (OMB) Circular A-76, stipulates that agencies must rely on the private sector for commercial-type services unless the government can provide them more economically. As such, guidelines that accompany Circular A-76 set down procedures for agencies to use in making comparisons of in-house and contract costs.

When agencies enter an in-house activity for cost comparison, its cost must reflect the most efficient and effective federal operation, as identified in management reviews. To win a contract, therefore, a private firm must beat the best price at which the government can provide a service. When the government wins a cost competition, agencies are expected to make improvements identified in management reviews. Under these procedures, the government can realize savings under A-76 even when activities remain in-house.

POTENTIAL COST REDUCTIONS UNDER THE CURRENT PROGRAM

Analysis by the Congressional Budget Office (CBO) shows that management improvements and contracting out under A-76 can substantially reduce federal costs. Savings in the near term, however, may be smaller than the total savings available since certain cash reductions for items, such as retirement, do not occur for many years. CBO, therefore, prepared two sets of estimates: one representing near-term cash savings; another measuring savings on an accrual basis. Under accrual accounting, costs are assigned to the period in which they are incurred, regardless of when cash disbursements actually take place. Thus, accrual estimates provide a measure of the total potential savings to the government, even though part of that savings may not take the form of lower cash disbursement for many years. Resources freed up as a result of A-76 activity could be applied to meet other program requirements or to reduce the budget deficit.

Uncertainties about the extent and outcome of A-76 activity in the future limits the accuracy of estimates concerning the program's impact. The CBO approach, which focuses exclusively on ongoing activities subjected to cost comparisons, relies heavily on DoD's record of experience with A-76, which is the most extensive and well documented among federal agencies. Based on its analysis of DoD and other data, CBO estimates assume that, over the next five years, agencies will perform A-76 reviews for activities covering the equivalent of 10,000 full-time workers annually. Of these, 65 percent will be contracted out, with savings averaging 35 percent of in-house costs. For activities remaining in-house, CBO estimates assume that management improvements would reduce costs, on average, by 20 percent.

Reductions in Costs on an Accrual Basis

Should current levels of effort continue, CBO estimates that management improvements and contracting out together could free up about 7,200

federal jobs per year and, on an accrual basis, reduce the cost of the activities reviewed each year by about 30 percent, or $130 million (full-year impact in 1988 dollars). Savings at the Department of Defense would total some $90 million, and about three-fifths of this amount could result from freeing resources associated with uniformed military personnel DoD sometimes uses in commercial activities. Contracting out alone would account for about 6,500 of the jobs freed up annually. These conversions would drop the cost of activities shifted by an average of 35 percent, or $100 million. For those activities remaining in-house, management improvements would free up 700 jobs annually, reducing costs by $30 million, or 20 percent.

Reductions in Costs on a Cash Basis

In the near term, a year's worth of effort under the A-76 program could generate cash savings of $70 million--compared with accrual cost savings of $130 million (full-year impacts in 1988 dollars). Over the five-year period from 1988 through 1992, some 36,000 jobs could be trimmed from the federal work force and cumulative cash savings could average about $200 million--$135 million from contracting out and $65 million from management improvements. Over that same period, cumulative cash savings at DoD could average $140 million. (These five-year estimates consider the effects of price changes and assume A-76 reviews occur evenly throughout the year. In addition, the savings from each year's A-76 activity are considered to continue through all five years covered by the estimates.)

OPTIONS FOR THE A-76 PROGRAM

The Congress may choose to take any one of a number of actions on the A-76 program--most would either increase contracting out or restrict it. The Congress also has several choices for carrying out any changes. For example, it may pass specific authorizing legislation or provide direction to agencies during the course of oversight and appropriation hearings.

As previously mentioned, proponents view commercial activity as beyond the proper purview of government and point to the savings available from private sector operation. Those who support more contracting out voice many of these same arguments. In the same way, advocates of less contracting out point to the concerns raised by critics of A-76--the loss of federal jobs, the cost increases that sometimes follow contracting out, the loss of quality, and the fairness of cost comparison procedures. Options I and II below describe different approaches to expanding contracting out.

Option III would restrict it. The various options described each offer the opportunity to reduce federal costs (see Summary Table). Of course, the Congress could always choose to make no changes and still achieve cash savings averaging about $200 million over five years.

Option I: Increase A-76 Reviews

The Congress could choose to expand contracting out by increasing the number of A-76 reviews that agencies performed annually. A number of options could be adopted to increase reviews. The Congress could, for

SUMMARY TABLE. AVERAGE ANNUAL COST AND JOB REDUCTIONS FROM OPTIONS FOR THE A-76 PROGRAM, 1988-1992

	Job Reductions	Reduction In Cash Costs (In millions of dollars)	Reduction In Accrual Costs (In millions of 1988 dollars)
The Current Program	7,200	200	325
Option I	14,400	400	650
Option II	20,000	140	305
Option III	4,000	370	430

SOURCE: Congressional Budget Office.

NOTE: Dollar amounts rounded to the nearest $5 million. Estimates represent the full effects of each option rather than changes from the current program. Both the cash and accrual estimates assume A-76 reviews occur evenly throughout a year and that savings from each year's reviews continue through the end of the five-year estimating period. In addition, cash savings have been adjusted to reflect price changes.

example, reduce legislative restrictions on contracting out. Because of such restrictions, agencies with large commercial work forces--such as the Veterans Administration--do few A-76 reviews. The Congress could also consider legislation requiring agencies to perform reviews according to a specific, accelerated schedule. Certain measures to reduce opposition to contracting out by federal employees might also increase A-76 activity. For example, a placement program for workers adversely affected by A-76 might reduce some of the more severe hardships on employees and, therefore, somewhat diminish employee resistance to A-76.

While it is not clear precisely by how much A-76 reviews would increase in response to these or other measures, it is not unreasonable to assume that activity could double--covering the equivalent of about 20,000 federal workers. Similarly, job reductions and savings could double.

Option II: Shift Activities Without Comparisons

Another approach to expanding contracting out would be to require the Executive Branch to abandon cost comparisons and shift activity to private firms regardless of particular cost impacts. Such an approach would be consistent with original federal policy, which stressed getting the government out of the business of providing commercial services. Without lengthy cost comparison procedures, agencies could contract out a greater number of activities, though the government would not realize savings in every case. If activities covering 20,000 jobs were shifted annually, reductions in cumulative cash costs would average $140 million through 1992. Reductions in accrual costs over five years would average $305 million annually. The cost increases that contracting out would cause for some programs might compound difficulties brought about by general measures to reduce federal spending. Moreover, without competitions that pit in-house against contract operations, private firms in some areas may have little incentive under this option to offer the government their best price.

Option III: Suspend Contracting Out

Taking an opposite approach, the Congress could suspend contracting out. Such a suspension might be permanent, which would recognize the continuing controversy surrounding the A-76 program, or it might be temporary, which would provide an opportunity for full consideration of specific reforms. This option assumes a five-year suspension of contracting out and a corresponding increase in management reviews to a level covering about 20,000 jobs annually. If agencies continued to find savings averaging

20 percent from management improvements, about 4,000 federal jobs would be freed up annually. Cumulative reductions in cash costs would average $370 million through 1992. Reduction in accrual costs would average $430 million per year. Without the threat of contracting out, however, the Congress would have to take action to ensure that agencies continued to find management improvements. It could, for example, reduce agency budget requests to reflect expected savings from improved management.

CHAPTER I

INTRODUCTION

Instead of performing commercial services in-house using federal workers, the federal government can often reduce its costs by contracting with a private-sector firm. In fact, Executive Branch policy set forth in the Office of Management and Budget's (OMB) Circular A-76 requires agencies, with some major exceptions, to use contractors for commercial services if such an approach is less expensive. 1/ Even so, in many agencies commercial activity is quite extensive. According to agency data, government commercial activity at the Department of Defense (DoD) alone encompasses about 380,000 federal jobs. These jobs support activity like food preparation, maintenance, warehousing, and data processing.

Contracting out for federal services has been a source of continuous and often heated controversy for the 30 years it has been federal policy. The Congress has shown its interest by making numerous legislative proposals on the subject. Some of the proposals would increase contracting out; others would reduce it. Because of current budgetary constraints, however, recent attention has focused on the potential savings from contracting out. In its recent budget reports citing potential cost reductions, OMB included a description of its efforts to increase Executive Branch contracting out. 2/ Given the current interest in the savings potential of contracting out, this Congressional Budget Office (CBO) study:

- Reviews commercial-type activity in government and the A-76 program;
- Describes the potential for reducing near- and long-term costs by contracting out under current policies and practices; and

---

1. Office of Management and Budget, *Circular No. A-76* (Revised), August 4, 1983. Implicit authority for Circular A-76 derives from 31 United States Code (USC) Section 1111 and other authority, which permits the government to undertake actions necessary to improve the economy and efficiency of its operations.

2. Office of Management and Budget, *Management of the United States Government* (1987), pp. 71-75; *Budget of the United States Government* (1988), p. m-9.

- Sets forth policy options for contracting out and their potential to reduce costs.

The reader should guard against confusing the contracting out program described in this report with other Administration efforts to increase reliance on the private sector, including those efforts designed to sell federal business-type operations. The term "privatization" is often applied to all such efforts, though they differ greatly in their approach to enlisting private-sector support, in potential budgetary implications, and in the concerns they raise about policy and implementation.

THE A-76 PROGRAM: HOW DECISIONS ARE MADE

Contracting out to curb costs is a common practice at all levels of the public sector. Private firms can offer services at lower costs for a variety of reasons: competition from other firms that encourages efficient operations, freedom from bureaucratic procedures, and flexibility to control their compensation costs and employment levels. Recent administrations, representing both political parties, have issued regulations to federal agencies that encourage the use of contracting out. The current federal program evolved from a policy, first formally promulgated in 1955, that stressed relying on the private sector for certain goods and services. As currently set forth, federal policy emphasizes relative costs, stipulating that federal agencies may not start or continue commercial services in-house when private firms can do the work for less. Moreover, revisions of federal policy in 1983 increased the emphasis on improving the management of commercial services. To this end, Circular A-76 and supplements to it establish requirements for monitoring the quality of services according to specific measures of output and timing, and for conducting management reviews to identify possible improvements in the in-house operation of services.

The A-76 program distinguishes commercial activities from inherently governmental functions to which it does not apply. A commercial activity, as defined under Circular A-76, is one providing goods or services an agency could obtain from a private source. Governmental functions, as defined by the circular, are those so "intimately related to the public interest that they mandate the use of federal employees." These functions include activities requiring the exercise of discretion in applying governmental authority or the use of value judgments in making decisions. Among the specific governmental functions identified in the circular are criminal investigation, program management, regulation of industry and commerce, control of Treasury accounts, and tax collection.

Cost Comparisons

To determine the most economical approach, A-76 requires agencies to compare the costs of providing a commercial service in-house with those of contracting it out. Agencies must prepare comparisons for their existing in-house commercial activities or when planning to expand an activity or to shift an activity back to in-house operation. A cost comparison handbook that supplements Circular A-76 prescribes the costs to be included when making comparisons and the methods for estimating them. 3/

When agencies estimate in-house costs for comparisons, they use the total cost of employee compensation, including the costs of retirement (computed on an accrual basis) and other fringe benefits. CBO's analysis shows that personnel costs represent, by far, the largest percentage of the total costs of in-house performance. According to a review of 1985 DoD cost comparisons, direct personnel costs made up nearly three-fourths of the costs estimated for performing activities in-house. Other in-house costs covered by cost comparison guidelines include direct overhead, material, and equipment. All in-house costs included in comparisons must assume that certain cost cutting measures will be carried out. (These measures are identified in management improvement studies required by A-76 and described in the next section.)

Under A-76 guidelines, contractor costs largely reflect the price of the best bid received from private firms. These bids are influenced by Department of Labor regulations that set minimum wages for workers under service contracts with the federal government on the basis of prevailing local compensation practices. 4/ To factor in certain costs that arise when the government converts work to service contracts, the cost comparison guidelines require that agencies make several upward adjustments to the contractor's price. These include federal expenses for contract administration and the cost of any severance pay should workers be laid off. The

---

3. The description of the cost comparison process presented in this section draws on information from the most recent cost comparison handbook. Because the bulk of cost comparisons that agencies prepare cover ongoing in-house work, procedures employed for such activities serve as the focus of the text's discussion. The cost comparison handbook sets out additional calculations, not described in the text, for expansions and conversions back to in-house performance.

4. Minimum wages for service contracts entered into by the federal government are set by the Secretary of Labor under authority of the Service Contract Act of 1965, 41 USC Section 351 and sections following.

guidelines also require that the contractor's price be reduced to reflect the federal income tax advantage to the federal government when work is contracted out. 5/ To move an activity to the private sector, the total cost of performing work by contract must be less than the cost of in-house operations, and the savings must exceed an amount equal to 10 percent of the in-house personnel-related costs. The 10 percent margin required, referred to as the "conversion differential," recognizes the risks and disruptions that can occur when activities shift to contract. The hypothetical cost comparison provided in the following box illustrates some of the cost components covered by A-76 comparisons.

Not all commercial activities must undergo cost comparisons. In most cases, civilian agencies do not have to conduct a cost comparison in contracting out activities that employ the equivalent of 10 or fewer full-time workers. At DoD, a cost comparison is not required for activities employing 45 or fewer civilian workers. In other situations, cost comparisons may be waived at the discretion of agency officials. They may also be waived when statutes or regulations designed to assist small businesses and other firms apply, when contractors already provide the government with satisfactory service, and when the activity simply represents a change in requirements. Moreover, as described later in this chapter, other categories of activities are exempt from A-76's competitive process altogether. For such exempt activities, agencies may forgo both cost comparisons and contracting out.

Management Studies of In-House Performance

In-house costs included in A-76 cost comparisons must reflect the most efficient and effective federal performance of the activity under review. To win a contract, therefore, a private firm must beat the most efficient price at which the government can provide the service. To ascertain the most efficient price, A-76 requires agencies to conduct reviews of their management to determine possible improvements in organization, staffing, and operating procedures. (These reviews are often prepared in conjunction with a formal description of the activity under review, called the performance work statement, that agencies use as the basis for developing in-house cost estimates and for soliciting bids from private firms.) A supplement to A-76 provides guidance to agencies on conducting management studies and suggests formats for documenting results. OMB requires

5. The A-76 cost comparison handbook includes tax rates by industry for use in calculating income tax deductions. OMB has not yet issued revisions to reflect recent tax reform.

AN A-76 COST COMPARISON

In this comparison, simplified for purposes of presentation, contracting out would reduce federal costs by an estimated $280,000. The activity would be slated for contracting out since the savings exceed the 10 percent conversion differential. (Dollar amounts are in thousands.)

In-house Performance Costs a/		Contract Performance Costs	
Personnel	1,095	Contract Price	1,250
Material and Supplies	215	Contract Administration	50
Overhead	190	One Time Conversion Costs	20
		Income Taxes	-100
Total	1,500	Total	1,220

Advantages of Contracting Out

Savings	280
Conversion Differential	110
Savings in Excess of Differential	170

SOURCE: Congressional Budget Office.

a/ Assumed to reflect cost reductions identified in management studies.

that management reviews, along with cost comparison and other A-76 information, be independently reviewed to verify fairness, accuracy, and completeness. Agency audit officials usually conduct these reviews.

In requiring management reviews, the government stands to gain from cost cutting improvements in operations even when activities remain in-house. DoD data for 1985 shows that improved management practices would reduce, by about one-fifth, the costs of commercial activities that won cost competitions with private firms and remained in-house. DoD managers report a variety of approaches to reducing the cost of providing commercial services, including combining functions to reduce supervisory requirements, consolidating facilities to reduce equipment and other costs, acquiring more productive equipment, and eliminating overgrading to reduce pay costs. 6/

A-76 sets forth no requirements for audits to determine if savings estimated from management reviews are actually achieved. To date, no governmentwide audit has been done. At the Department of the Navy, an audit of 15 A-76 reviews found that for all six activities that remained in-house, improvements in management had been fully carried out. 7/ The audit, by the Navy's Inspector General, covered a sample of A-76 actions completed from 1983 through 1985. The 15 reviews represented about 3 percent of all reviews the Navy had completed during that time.

CURRENT SERVICE CONTRACTING

A service contract is a relatively simple concept. Generally, it represents a contractual agreement that a private firm will provide services to a federal agency. The government compiles no data on the total value of contracts awarded to private firms as a result of cost comparisons and other procedures prescribed by A-76. Analysis of data from the Federal Procurement Data Center (FPDC), however, indicates widespread and growing use of private firms to provide A-76-type commercial services. 8/ New contracts and contract renewals

---

6. For a discussion of techniques used to lower the cost of support services at military bases, see John Handy and Dennis O'Connor, "A-76 Competitions: 'How Winners Win'" *Defense Management Journal*, vol. 21 (Third Quarter, 1985).

7. Auditor General of the Navy, *Fiscal Year 1986 Post Decision Commercial Activity Reviews* (Department of the Navy, December 1986).

8. The Federal Procurement Data Center (FPDC) maintains an automated system of federal procurement information. By focusing on commercial-type service contracts, CBO totals exclude amounts for weapons and other product procurement. FPDC totals cover any multiyear contracts and renewals, thereby making interpretation of data difficult.

awarded to private firms by federal agencies increased, in constant 1983 dollars, about 10 percent over the three-year period from 1983 to 1985--from $32.8 billion to $36.0 billion (see Table 1).

These totals cover amounts for services typically considered for contracting out under A-76. Data, for example, show large increases in awards for maintenance, repair, and modification of equipment. FPDC data, however, do not specifically identify contracts resulting from agency efforts under A-76. In addition, totals may include amounts for services--such as those purchased on a one-time, noncontinuous basis--to which cost comparisons and other A-76 procedures do not apply. Because of these limitations, data should not be interpreted as providing an assessment of levels of effort under A-76. In particular, one must guard against attributing changes in contracting nondefense services to changes in levels of effort under A-76. In fact, civilian agencies complete few cost comparisons. FPDC does, however, provide an estimate of the extent of federal reliance on the private sector for commercial-type services.

Over the three-year period from 1983 to 1985, awards made by DoD increased more than those of nondefense agencies. Awards at DoD increased 17 percent, rising from $17.3 billion in 1983 to $20.2 billion in 1985. Two agencies account for almost all of the growth in awards for nondefense agencies--the Department of Energy (DOE) and the National Aeronautics and Space Administration (NASA). The growth in awards at DOE reflect increased contracting for nuclear and related research. At NASA, increases reflect growth in requirements for ADP maintenance, and for equipment maintenance for the Space Shuttle program.

TABLE 1. SERVICE CONTRACT AWARDS 1983-1985
(In billions of 1983 dollars)

	1983	1984	1985	Percent Increase 1983-1985
Defense	17.3	18.5	20.2	17
Nondefense	15.5	15.7	15.8	2
Total	32.8	34.2	36.0	10

SOURCE: Congressional Budget Office from data provided by the Federal Procurement Data Center.

POTENTIAL FOR ADDITIONAL CONTRACTING OUT

Despite the growth in service contracts over the past several years, federal agencies have far from exhausted the opportunities for contracting out. Estimating the total potential is difficult, however, given the uncertainties about which of the many and diverse activities conducted by the government would qualify as commercial under A-76 definitions. 9/ One approach to estimating the level of commercial activity in government considers federal employment in commercial-type occupations. According to CBO calculations, full-time civilian employment in occupations likely to be engaged in providing commercial services totaled 1.4 million as of October 1985. (Data cover the Executive Branch, excluding the U.S. Postal Service.) This total covers a wide variety of white- and blue-collar occupations. Significant concentrations were evident in activities such as maintenance, installation, and operation of equipment (accounting for 12 percent of the estimated in-house commercial work force), as well as in general administration and support (34 percent of total). Engineering and medicine also account for a significant number of covered workers (each representing about 10 percent of total). About three-fifths of these workers support activities at DoD.

While such occupation-based estimates provide one way of assessing the extent of commercial activity in government, they most likely overstate the size of the commercial work force that agencies will consider for contracting out. Although CBO looked at occupations such as data transcribing and custodial work that typically support commercial activity, some workers in these occupations may support governmental activity not covered by A-76. 10/ Data transcribers supporting commercial work such as library cataloguing, for example, are indistinguishable from those supporting governmental activities such as basic research. More important, only a fraction of the estimated commercial work force is engaged in activities that will be shifted to contract or even subject to cost comparisons because of A-76 exemptions.

---

9. A recent General Accounting Office (GAO) report surveying studies of the savings potential of contracting out cites seven different estimates of the number of commercial-type positions in government. They range from just over 200,000 to 1 million. See GAO *Federal Productivity, Potential Savings from Private Sector Cost Comparisons* (December 1986), p. 11.

10. Major occupational groups excluded from the CBO estimate of the in-house commercial work force include program management and administration; personnel management; investigation and inspection; selected legal and related occupations such as contract representative, social insurance examiner, and IRS officer; selected engineering occupations; and financial management.

Inventories of agencies' commercial activities provide another perspective on the scope of federal work subject to the government's A-76 policy. Circular A-76 requires agencies to prepare inventories that list all their commercial activities. To date, however, few agencies other than DoD have prepared such inventories, and the DoD inventory is not exhaustive. DoD updates its inventory annually to expand coverage, to consider any changes in the eligiblity of activities for contracting out, and to reflect the progress of operations through the A-76 process. DoD inventory data for 1985 show commercial activities covering the equivalent of about 380,000 full-time civilian jobs, which represent about 35 percent of the civilian work force at the department. 11/ Another 160,000 full-time uniformed military jobs support commercial work at DoD. The civilian work force estimate derived from DoD's inventory represents only about half of the occupation-based estimate of DoD's commercial work force. Information from inventories, however, provides a catalogue of activities that will serve as a focus of agency A-76 efforts in the forseeable future. If current levels of effort continued, it could take more than a decade to complete cost studies for activities in the 1985 inventory. Of course, many of the inventoried activities will not be likely to face cost competitions with private firms because of statutory and other exemptions.

Exemptions

Certain commercial activities involving large numbers of federal jobs are exempted from being contracted out by provisions in both A-76 and a number of statutes. By far, the exemptions covering the largest number of commercial jobs apply to specific agencies and activities.

At DoD, 275,000, or about three-quarters, of the 380,000 inventoried commercial jobs support activities that are exempt from contracting out. About 85 percent of these jobs fall under exemptions provided for by both provisions of A-76 and statutes that cover activities meeting national defense needs, such as maintenance and repair of combat equipment. 12/

---

11. In DoD's inventory, a full-time job is the work done in a year on a full-time basis. Under such a reporting system, for example, the work done throughout the year by two half-time workers counts as one full-time job.

12. See Office of Management and Budget Circular No. A-76 Paragraph 8b and 10 USC Section 2304 note. About three-quarters of the 275,000 estimate has been authenticated by Department of Defense review. DoD inventory data show large numbers of employees in commercial activities awaiting reviews of their eligibility for contracting out. CBO estimates assume that these activities would be determined to be exempt or nonexempt in the same proportion as activities already reviewed.

Other much smaller statutory exemptions at DoD apply to firefighters and to most guards. (The exemption covering guards expires in 1988.) The total DoD exemptions also include 30,100 jobs that A-76 allows to remain in-house because of the potential for delay and disruption, lack of a private-sector source, or higher costs in the private sector.

Among nondefense agencies, major exemptions apply to the Veterans Administration (VA), the General Services Administration (GSA), and the Department of Interior. According to CBO calculations, about 200,000 workers fall under such exemptions. The excluded VA positions, covered by provisions of both A-76 and certain statutes, support activities in hospitals and other health-care facilities and are intended to protect the quality of health services available to veterans. 13/ They apply, however, to all jobs in medical centers including many incidental to direct patient care. At GSA, statutory exemptions apply to messengers, guards, elevator operators, and custodians. 14/ At the Interior Department, statutory provisions exempt contracting out at the Bureau of Land Management, the Fish and Wildlife Service, and the National Park Service. 15/

THE DEBATE ON CONTRACTING OUT

Concern about budgetary implications is only one of many raised in the debate on contracting out. The debate has continued through successive revisions of the federal policy and has centered on such issues as fairness, quality, and accountability. The primary concern, however, has always been how best to obtain the services required by government, whether from private firms under contract or in-house from federal workers. Both sides in the controversy continue to muster largely anecdotal evidence in support of their case. 16/

---

13. See Office of Management and Budget Circular No. A-76 Paragraph 8b and 38 USC Section 5010.

14. As provided for in Continuing Appropriations, Fiscal Year 1987 (P.L. 99-591).

15. See 43 USC Section 1457a.

16. For further discussion of the case in support of contracting out, see James T. Bennett and Manuel H. Johnson, *Better Government at Half the Price* (Ottawa, Illinois and Ossining, New York: Caroline House Publishers, Inc., 1981). The case against contracting out is made by the American Federation of State, County and Municipal Employees in *Passing the Bucks* (Washington, D.C.: AFSCME, 1983).

The A-76 policy is based in part on the principle that the government should avoid providing goods and services that are available from private firms. In so doing, according to this view, the government encourages the kind of initiative and competition that strengthens private-sector markets. Federal policy also reflects the belief that competition among private firms for federal contracts will result in the government obtaining better quality services for less cost.

Proponents of contracting out--which include contractors, trade associations, and some senior federal officials--believe that the savings potential of contracting out gives the government a chance to control its costs without having to reduce services. Contracting out, its adherents argue, enhances management flexibility for several reasons: it avoids complex civil service rules, and it addresses requirements for part-time work and for specialized staff and equipment without having to increase permanent employment. While acknowledging the occasional problems caused by poorly prepared cost comparisons and bad contractors, proponents believe such occurrences are not arguments against contracting out, but arguments for better management and oversight of contractor performance.

Critics of contracting out--which include public employee organizations and some federal managers--marshal a variety of arguments against the practice. Public employee organizations view contracting out as a backdoor device for doing away with federal jobs. They argue that changes in the size of the work force or its compensation should be made directly through pay and program reform. Some critics argue that the savings from contracting out are bought at the price of making the government party to substandard employment practices in certain firms. They also believe that when agencies contract out, they are substituting work performed by experienced and loyal employees for work performed by private firms that may employ inexperienced workers and that may have loyalties torn by the competing demands of agencies, other customers, and boards of directors. Moreover, critics maintain, shifting work to contract can lower employee moral and disrupt normal operating procedures.

Quality, Control, and Accountability

Notable among the critics of contracting out are federal managers, who express concern that, despite potential savings, contracting out can cause a serious decline in the quality of services. Unfortunately, few systematic, comprehensive reviews of service quality under contracting out have been

done. 17/ The literature is replete, however, with anecdotes describing the bitter experience of some agencies with contract services. Problems can arise because contractors, in an effort to reduce their costs, may use inexperienced or transient workers, reduce supervision, or ignore contract requirements. Managers note that the ability of an agency to carry out basic program responsibilities can be threatened by business failure and strike action--occurrences not typical of government operations--as well as by the loss of control and accountability that can accompany turning service performance over to outsiders. Problems of control and accountability can be particularly acute when contract services are conducted at locations far from agencies and where the number and variety of contractors make oversight difficult. Statutory limitations on contracting out for medical services and for certain national defense functions were enacted, in part, out of such concerns.

Critics of these two restrictions counter that the success of a wide range of health-care and defense-related activities by private firms is evidence that restrictions are not necessary. DoD military hospitals, for example, contract out for a variety of medical activities, including ambulance service, nutritional care, medical supply services, and outpatient care.

Cost Increases and Cost Comparisons

Critics also argue that contracting out, rather than saving money, can often result in higher costs. They express concerns about cost increases that occur after the job has been contracted out--increases of the sort that would not occur if activities were kept in-house. For example, when contractors fail to provide the level or quality of service for the price agreed to, agencies may have to undergo costly procedures to replace contractors or renegotiate contracts, although failures that lead to such procedures are not always the contractors' fault. In some cases, recompetition or renegotiation of contracts may occur because of errors or ambiguities in agency descriptions of the work required from contractors. Some evidence exists to support such concern, but nothing that suggests as

17. A 1985 RAND study addressed the question of the quality of vehicle maintenance services at seven Air Force bases. Comparing the rates at which vehicles were out of service, the RAND study concluded contract and in-house vehicle maintenance operations performed equally well. On the other hand, an analysis of interview data permitted the authors to draw no firm conclusions about the effects of A-76 procedures on quality. See Ross M. Stolzenberg and Sandra H. Berry, *A Pilot Study of the Impact of OMB Circular A-76 on Motor Vehicle Maintenance Cost and Quality in the U.S. Air Force* (Santa Monica: RAND, 1985).

severe a problem as some critics contend. A 1985 General Accounting Office review of 20 conversions to contract at DoD found subsequent increases in the cost of contract operations in all but one case. Many of the increases, however, would have occurred even had the activities remained in-house, and savings were still realized for 17 of the activities. 18/ A more comprehensive DoD review, described in the Appendix, found substantial savings from contracting out despite subsequent small cost increases in some cases.

A related concern raised by both proponents and critics of contracting out pertains to the validity of the cost comparison guidelines prescribed under supplements to A-76. Those on both sides of the A-76 debate feel that the guidelines are unfair and bias decisions for or against contracting out, depending on their perspective. OMB periodically reviews its cost comparison procedures, however, and over the years it has attempted to address major concerns about the program. For example, in revisions since 1983, OMB responded to criticism that the method prescribed for estimating federal retirement costs had become outdated by requiring the use of more recent data from the Office of Personnel Management (OPM). OMB also addressed a concern about the cost and complexity of its procedures by simplifying some costing methodologies and by waiving cost comparison requirements for small activities. It also made changes to account more fully for the costs of compensation available to federal workers who are laid off when work shifts to private firms.

A 1985 study conducted by Management Analysis Incorporated for the Small Business Administration largely supports current procedures. The study measured the validity of A-76 cost comparison guidelines against accepted economic and accounting principles. 19/ It concluded that, with the exception of the method prescribed for estimating contract administration costs, the comparison guidelines provide a reasonable basis for estimat-

---

18. General Accounting Office, *DoD Functions Contracted Out Under OMB Circular A-76: Contract Cost Increases And the Effects On Federal Employees* (April 1985). The GAO study covered a judgmental sample of cost comparisons and, in the absence of more detailed information, assumed pay increases granted to contract workers after conversion did not reduce savings.

19. Management Analysis, Inc., *Comparison of the Costs of the Government Versus the Private Sector in Providing Goods and Services to the Government* (Vienna, Virginia: Management Analysis, 1985).

ing costs. 20/ Nevertheless, debate continues about estimating procedures for various cost components. Concern arose recently about legislatively mandated procedures for estimating costs of the new retirement system created by the Federal Employees' Retirement System Act of 1986. 21/ The new system covers federal employees hired beginning in January of 1984 and other employees who may elect to join. OMB halted contracting out from June through October 1986, while it revised cost comparison guidelines to comply with specific requirements of the Federal Retirement Act. As described in the Appendix, cost factors specified in revised guidelines, to be consistent with specific legislative requirements, slightly understate federal costs and can somewhat distort cost comparison decisions.

20. The A-76 cost comparison handbook provides a table with standardized cost estimates for contract administration that agencies may use in preparing cost comparisons. The costs provided vary by size of the work force engaged in the activity under review. The study by Management Analysis Incorporated suggested the use of costs that more accurately reflect the actual resources devoted to contract administration. A-76 guidelines, however, permit the use of alternative cost estimates when they more accurately reflect actual costs.

21. The Federal Employees' Retirement System Act of 1986 (Public Law 99-335) requires the use of certain A-76 cost factors in Title II, Section 307.

CHAPTER II

COST REDUCTIONS UNDER THE CURRENT PROGRAM

Under current levels of effort, the government's contracting out program and the management reviews associated with it offer the potential for large economies to the government. Near-term cash savings, however, are considerably smaller than total economies that would be ultimately achieved. This chapter provides estimates of total economies, measured on an accrual basis, and near-term cash reductions.

CBO'S ESTIMATING PROCEDURES AND BASIC ASSUMPTIONS

The estimates in this chapter represent the amounts by which agencies could reduce the operating cost for ongoing in-house activities that are subject to cost comparisons. Additional economies, beyond the scope of this report, may result from decisions to use contract over in-house workers for new requirements, and from other management initiatives to increase both efficiency and reliance on private-sector services. 1/

In reducing operating costs by improving management and contracting out under A-76, agencies free up resources that may reduce deficits or that may, through reallocation, offset other program costs. At DoD, savings under the A-76 program would almost certainly fulfill other obligations. A-76 reviews, for example, often result in the freeing up of uniformed personnel to pursue activities more distinctly military in nature. If the Congress wishes, it could place greater emphasis on the A-76 program for budget reduction. Legislation has already been introduced, for instance, that would return savings from A-76 to the U.S. Treasury. 2/

---

1. Management improvements of federal operations and contracting out sometimes occur without cost comparisons. For example, agencies may conduct management reviews for activities exempt from contracting out or for activities covered by the Administration's productivity improvement program--an effort separate from A-76. Agencies may also directly contract out certain small activities. Because the number of direct conversions is uncertain and cost comparison data is lacking, a precise impact of direct conversions cannot be ascertained.

2. S. 909 proposes that agencies pay into the general fund of the Treasury amounts saved as a result of contracting out.

Basis for CBO Estimates

Developing estimates of savings available under the A-76 program is difficult, given uncertainties about the number and outcome of A-76 reviews that agencies will conduct in the future. In preparing its estimates, CBO relied heavily on DoD's experience. Among federal agencies, DoD has had the most extensive and well documented A-76 program, while experience and information for other agencies is limited or nonexistent.

CBO's estimates assume that about 65 percent of the activities reviewed annually under A-76 will be contracted out and that savings for those activities will average 35 percent of in-house costs. For activities that remain in-house, CBO's estimates assume that management improvements will reduce costs, on average, by 20 percent. These averages are consistent with recent DoD experience (see Appendix). Moreover, they take into account some events, such as retirement reform, that now influence the outcome of A-76 reviews.

DoD's average savings under A-76 has been fairly stable over the past several years (see Appendix Table). To find other trends that might help predict future results, CBO examined detailed data on about 180 reviews completed in 1984 and 1985; it found none. 3/ In making projections on the basis of past experience, CBO assumes agencies will continue to find activities that can generate substantial savings when subjected to A-76 review. Certainly, nondefense agencies have only begun to consider the large numbers of activities eligible for A-76 review. At DoD, as previously noted, agency officials continue to revise and update their inventory as new commercial activities are identified. Moreover, data suggest that DoD has large employment in occupations with activities that traditionally generate substantial savings when subjected to A-76 review. In five occupations alone--ADP, audio-visual production, food preparation and serving, laundry service, and custodial work--DoD employed about 70,000 full-time workers as of October 1985.

---

3. CBO performed statistical tests to ascertain if the geographic location of an activity or the type of activity had any bearing on the percentage of savings realized. The results were essentially negative, which is not especially surprising in view of the highly decentralized administration of the program. Even if meaningful patterns had been identified, they would be of questionable value in predicting the outcome of future A-76 activity, given uncertainties about the composition of agency inventories and the nature of activities that agencies will select for review.

CBO applied the average savings and conversion rates it derived from DoD data to estimates of in-house costs. It assumed agencies will conduct reviews of activities covering the equivalent of 10,000 full-time jobs--7,000 at DoD and 3,000 at non-DoD agencies. Details concerning the derivation of the in-house costs of these activities and CBO's analysis of DoD A-76 data are provided in the Appendix.

POTENTIAL COST REDUCTIONS UNDER THE A-76 PROGRAM

Contracting out and management improvements under the government's A-76 program can substantially reduce both the near- and long-term costs of government operations. When an activity is contracted out, for example, the government realizes cash savings in retirement costs years later when employees in the activity would have retired and begun to collect pensions.

Accordingly, CBO prepared two sets of estimates of the savings potential of the A-76 program, one representing near-term cash savings and another measuring savings on an accrual basis. Under accrual accounting, costs are assigned to the period they are incurred, regardless of when cash disbursements actually take place. Accrual estimates thus provide a measure of the total potential savings to the government even though part of that savings may not take the form of lower cash disbursement for many years. In fact, A-76 guidelines require accrual accounting for costs.

Potential Cost Reductions on an Accrual Basis

On an accrual basis, CBO calculates that the annual in-house cost of the activities undergoing A-76 reviews over the next five years will be about $440 million per year (in 1988 dollars). Under CBO estimating assumptions, 65 percent of the 10,000 full-time jobs covered by the activities reviewed each year would shift to private firms, and management improvements would free up another 700 jobs. As a result, federal costs would fall by about 30 percent or $130 million per year (full-year impact in 1988 dollars; see Table 2). At DoD, some 5,040 jobs could be freed up every year, reducing annual in-house costs of $310 million by $90 million. Uniformed personnel in commercial activities at DoD would represent almost three-fifths of the labor resources saved by A-76. Savings for nondefense agencies would total $40 million. These smaller cost reductions for nondefense agencies primarily reflect less A-76 activity.

According to CBO estimates, contracting out alone could reduce the annual cost of activities reviewed by about $100 million, an amount equal to

about 35 percent of what it costs to run the contracted activities in-house. (At DoD, annual savings just from contracting out total an estimated $70 million.) For activities remaining in-house after a comparison of costs, management improvements could reduce costs on average by about 20 percent, or $30 million.

TABLE 2. REDUCTIONS IN ACCRUAL COSTS FROM ONE YEAR'S A-76 ACTIVITY UNDER CURRENT LEVELS OF EFFORT
(Full-year effects in millions of 1988 dollars)

	Activities Remaining In-house	Activities Contracted Out	Total
Annual Accrual Cost of Activities Reviewed			
All Activities	155	285	440
Defense	110	200	310
Nondefense	45	85	130
Savings			
Management Improvements			
All activities	30	0	30
Defense	20	0	20
Nondefense	10	0	10
Contractor Operation			
All activities	0	100	100
Defense	0	70	70
Nondefense	0	30	30
Combined Impact			
All activities	30	100	130
Defense	20	70	90
Nondefense	10	30	40

SOURCE: Congressional Budget Office.

NOTE: Figures rounded to nearest $5 million.

TABLE 3. ANNUAL CASH SAVINGS FROM ONE YEAR'S A-76 ACTIVITY UNDER CURRENT LEVELS OF EFFORT (Full-year effects in millions of 1988 dollars)

	Activities Remaining In-house	Activities Contracted Out	Total
Management Improvements			
All activities	20	0	20
Defense	15	0	15
Nondefense	5	0	5
Contractor Operation			
All activities	0	50	50
Defense	0	35	35
Nondefense	0	15	15
Combined Impact			
All activities	20	50	70
Defense	15	35	50
Nondefense	5	15	20

SOURCE: Congressional Budget Office.

NOTE: Annual cash savings represent decreases in budget outlays and any net losses in federal collections from employee contributions. Figures rounded to nearest $5 million.

Reductions in Cash Costs

According to CBO estimates, the A-76 program's contribution to reducing the near-term costs of federal operations amounts to about half of its potential accrual cost savings. Average cash savings from one year's effort to improve federal management and to contract out would total about $70 million on a full-year basis--compared with the $130 million reduction in accrual costs (see Table 3). As previously mentioned, smaller cash savings mainly reflect the fact that cash savings in retirement costs do not materialize right away. 4/ Over a five-year period, about 36,000 federal

4. In addition, the A-76 program causes slight net cash losses in certain funds held by the government for retirement-related benefits. These declines, allowed for in CBO estimates, occur as the result of a net loss in employee contributions to federal Social Security, Medicare, and federal employee retirement funds. Under the unified federal budget, a decline in such cash contributions increases budget deficits. A fraction of the decline is offset by reduction in federal outlays for off-budget investment of employee contributions to retirement thrift plans.

jobs could be freed up, assuming agencies continue A-76 reviews covering 10,000 full-time workers annually. As a result, cumulative reductions in cash costs would average about $200 million (see Table 4). For DoD activities, estimated cumulative cash savings would average $140 million.

According to CBO estimates, for DoD and nondefense activities combined, total reductions in cash resources from contracting out could average about $135 million through 1992. Another $65 million in cash savings would be realized from improved management.

TABLE 4. CUMULATIVE CASH SAVINGS UNDER CURRENT LEVELS OF EFFORT, 1988-1992 (In millions of dollars)

	1988	1989	1990	1991	1992	Five-Year Average
Management Improvements						
All activities	15	35	65	95	130	65
Defense	10	25	45	65	90	45
Nondefense	5	10	20	30	40	20
Contractor Operation						
All activities	20	70	125	190	255	135
Defense	15	50	90	135	180	95
Nondefense	5	20	35	55	75	40
Total						
All activities	35	105	190	285	385	200
Defense	25	75	135	200	270	140
Nondefense	10	30	55	85	115	60

SOURCE: Congressional Budget Office.

NOTE: Figures rounded to nearest $5 million. Five-year averages rounded independently. Estimates include the effect of cost increases resulting from higher prices and assume A-76 reviews occur evenly throughout the year. In addition, the savings from each year's A-76 activity are considered to continue through the end of the five-year period covered by the estimates.

CHAPTER III

OPTIONS FOR THE GOVERNMENT'S CONTRACTING OUT PROGRAM

Most actions the Congress would be likely to take in addressing the government's A-76 program would either increase contracting out or restrict it. The options described in this chapter represent both approaches.

Whatever the Congress decides is the best course of action to take with regard to A-76, it may choose from a number of methods to carry out its will. It could decide to bring about change by enacting specific authorizing legislation, or it could do so as part of its detailed review of agency appropriation requests. Appropriation action could take the form of specific language in appropriation acts or direction to executive agencies in accompanying committee reports. The Congress may also pursue changes as part of the exercise of its oversight responsibilities. Of course, it could also decide the current program is best and take no action.

As described in Chapter I, those who support contracting out, under current or expanded levels of effort, regard commercial activity as beyond the proper purview of government. They contend that, with federal deficits likely to continue, the A-76 program offers a way to reduce federal costs without reducing programs. Moreover, they argue that problems with contracting out can largely be dealt with through careful procurement management and better monitoring of contractor performance. Critics of contracting out, who would oppose most any expansion of the program, express concern about the loss of federal jobs to private firms, maintaining control of and accountability for activities performed by those outside government, and possible decreases in the quality of services received. Other critics complain about cost increases that sometimes follow contracting out and about the accuracy of cost comparison procedures.

OPTIONS FOR POTENTIAL COST REDUCTION

As Table 5 illustrates, the various options described in this chapter offer the potential to reduce federal costs, although they do so to varying degrees. The amounts presented represent the full effect of each option rather than changes from the current program. CBO adopted this approach because its

baseline projections of current policies for major operating programs make no explicit assumptions about changes in either the size of the federal work force or federal costs that would result from management improvement efforts such as A-76. 1/

As with the estimates in the previous chapter, those presented here reflect assumptions about the portion of activities to be contracted out and about projected average savings. Both assumptions are based on the extensive experience DoD has had with A-76. Resources freed up under any of the options described could be applied to reducing federal deficits or to fulfilling other program requirements. CBO's estimates assume that options to expand the contracting out program could be carried out largely without layoffs. Even so, expanded contracting out could prove a hardship for some employees. Achieving an orderly transfer of jobs becomes increasingly difficult as more activities are affected. As a result, some employees may have to face unwelcome changes in job location, level of responsibility, and working conditions. About 70 percent of the estimated cost and job impacts described below pertain to activities at the Department of Defense.

The Current Program

Should the Congress make no changes in the A-76 program, management improvements and contracting out under current efforts would together generate cumulative reductions in cash costs averaging $200 million over the 1988 through 1992 period (see Table 5). On an accrual basis, cost reductions over the same period would average $325 million. The program would free up about 7,200 federal jobs each year.

Option I: Increase The Number of A-76 Reviews

This option would expand contracting out by increasing the number of A-76 reviews that agencies do each year. Critics of current efforts have long maintained that agencies simply do not do as many reviews as they could. Agencies regularly fail even to perform as well as they tell OMB they will. For example, according to unpublished OMB data for the 1984 through 1986 period, agencies promised annual reviews of activities that, when combined, covered about 30,000 jobs but completed reviews for only about 10,000 of them per year. OMB set goals for agencies during the three-year period

1. The implicit assumption in CBO baseline projections is that current levels of activity under A-76 continue throughout the estimating period.

that would have totaled reviews covering almost 35,000 jobs per year. Moreover, agencies appear to have the resources available to expand annual reviews; they employ nearly 25,000 mid-level management and program analysts capable of conducting cost comparisons and management studies. Of the various options described in this chapter, expanding A-76 reviews offers the greatest potential to reduce federal costs.

The Congress could do a number of things to expand A-76 activity. It could, for example, reduce legislative restrictions on contracting out. While concern for national security and the quality of care provided to veterans gave rise to the largest legislative restrictions on contracting out, some analysts argue that they are overly restrictive and overused. Because of such restrictions, for example, the Veterans Administration does virtually no

TABLE 5. AVERAGE ANNUAL COST AND JOB REDUCTIONS FROM OPTIONS FOR THE A-76 PROGRAM, 1988-1992

	Job Reductions	Reduction In Cash Costs (In millions of dollars)	Reduction In Accrual Costs (In millions of 1988 dollars)
The Current Program	7,200	200	325
Option I	14,400	400	650
Option II	20,000	140	305
Option III	4,000	370	430

SOURCE: Congressional Budget Office.

NOTE: Dollar amounts have been rounded to the nearest $5 million. Both the cash and accrual estimates assume A-76 reviews occur evenly throughout a year and that savings from each year's reviews continue through the end of the five-year estimating period. In addition, cash savings have been adjusted to reflect price changes.

contracting out despite its very large commercial work force. Reducing statutory restrictions, however, would run counter to some legislation now pending in the Congress. 2/

Providing a specific statutory base for contracting out, which is now an Executive Branch initiative, might also encourage more A-76 activity. Such a statute might well include schedules of reviews to be undertaken by agencies. Legislation of this sort has already been proposed. 3/ The Congress might also consider encouraging more A-76 activity by taking action to reduce employee resistance to contracting out. It could, for example, consider mandating job placement in the same commuting area for federal employees affected by A-76. 4/

While it is difficult to predict precisely by how much the program would grow in response to the this option, it is not unreasonable to assume agencies could review activities covering 20,000 jobs annually--twice the current level. Accordingly, cost and job reductions under the program would probably double.

Option II: Shift Activities To The Private Sector Without Cost Comparisons

As another approach to expanding contracting out, the Congress could require the Executive Branch to shift activities to private firms without making cost comparisons. This approach would be in the spirit of the government's original contracting out policy, which rested on the belief that the government simply should not be in the business of providing support services available from commercial sources. The option would place maximum reliance on the private sector. Activities that would otherwise have

---

2. S. 736, introduced as H.R. 1302 in the House, would expand existing prohibitions in contracting out at the Department of Defense.

3. Bills S. 265, H.R. 136, and H.R. 1606 would all provide statutory authority for contracting out. In addition, the two House bills recommend adoption of schedules that would mean completing cost studies for all eligible activities over a five-year period.

4. Another, but perhaps costly, approach could be modeled after ideas advanced by the Office of Personnel Management (OPM). OPM believes employee opposition to contracting out would be reduced if the government required private firms seeking federal contracts to give stock in the enterprise to federal employees who must leave government because of the conversion. Some further details about OPM's ideas are provided in the *Budget and Program* newsletters of August 15, 1986 and March 27, 1987.

remained in-house to reduce federal costs would shift instead, and agencies would most likely complete more procurement actions in the absence of lengthy and controversial cost comparison procedures. The option would not maximize savings, however, since economies would no longer be guaranteed for every activity converted. (Agencies could avoid extraordinary cost increases it they were permitted to forgo contracting out in cases where private firms clearly could not provide the service at a reasonable price.)

The cost increases for some activities under this approach might compound the difficulties agencies experience in complying with any other budget reduction requirements they face. In addition, without a competitive process that pits in-house against contract operations, private firms in locations where they encounter little competition would not have much, if any, incentive to offer the government their best price. Moreover, agencies would give up cost reductions from management improvements for those activities that would have otherwise remained in-house.

If agencies shifted some 20,000 jobs each year, cumulative average annual reductions in cash costs through 1992 would total $140 million--only about 70 percent of the savings under the current program. Accrual savings over the same period would average $305 million.

Option III: Suspend Contracting Out

Moving in the opposite direction, the Congress could act to suspend contracting out. Such a suspension might be permanent, in recognition of the continuing controversy surrounding the A-76 program, or it could be temporary, providing an opportunity for both the Executive and Legislative Branches to consider fully any changes in the program. A temporary moratorium, for example, would permit the government to study more thoroughly the effect of federal retirement reform on federal costs.

Under this option, contracting out would be suspended through 1992 and management reviews would be expanded to help offset lost savings. CBO estimates assume that agencies could conduct reviews covering about 20,000 jobs per year. Without the threat of contracting out, however, the Congress would have to consider methods to help ensure that agencies continued to find substantial management savings. In the past, such savings have averaged around 20 percent of in-house costs. The Congress might, for example, reduce agency budget requests to reflect expected savings from management improvements. It could also require audit reports to verify that improvements cited in management reviews were carried out.

Under this option, if agencies conducted annual reviews covering some 20,000 jobs, management improvements could permit the government to free up some 4,000 jobs annually. Potential reductions in cash costs would average $370 million through 1992, while average annual accrual savings would amount to $430 million. (These CBO savings estimates assume agencies would continue to find savings averaging 20 percent of in-house costs.)

APPENDIX

ESTIMATING POTENTIAL COST REDUCTIONS FOR THE A-76 PROGRAM

The Congressional Budget Office calculated the impact of the A-76 program by first estimating the in-house costs of activities covered by future A-76 reviews. These estimates assume that, annually from 1988 through 1992, agencies will conduct A-76 reviews for activities covering the equivalent of 10,000 full-time workers--7,000 at DoD and 3,000 at non-defense agencies. According to unpublished OMB data on A-76 accomplishments, the 10,000 estimate represents about the average number of jobs covered per year by A-76 reviews for fiscal years 1984 through 1986. The estimates further assume jobs covered by future A-76 reviews will have an average salary of $23,900, in 1988 dollars, based on data from OPM on pay and employment in commercial-type occupations. CBO derived total in-house costs from pay, assuming a relationship between the two costs consistent with data from DoD cost comparisons.

Against its estimates of in-house cost, CBO then applied key estimating factors representing assumptions concerning the rate of conversion to contract and the average savings per A-76 review. These factors were derived from a detailed analysis of DoD data. CBO had available the results of A-76 activity at DoD for the years 1983 through 1986. In addition, CBO was able to obtain the individual cost comparisons prepared for 1985, which it used to consider the effects of adjustments in various cost factors included in cost studies. 1/

AVERAGE SAVINGS

The following table compares the average savings rates implicit in CBO estimates with those achieved by DoD for the three-year period following the major revisions in A-76 policy which occurred in 1983.

Generally, the CBO assumptions are conservative when compared with those generated from DoD data. The conservative factors reflect several

1. DoD's Commercial Activities Directorate provided the cost comparison data base, CBO edited it to correct for a few minor errors and omissions.

considerations, although no precise adjustment could be substantiated. First, private-sector salaries for many occupations continue to grow more than those in the federal government, potentially reducing the margin of savings that contractors can offer to government. Second, the government may not always realize the full savings from jobs abolished under A-76, because of benefits available to employees in the affected jobs. Federal workers in jobs abolished, for example, may take the position of lower-paid workers with less seniority while retaining their previous grade and pay.

APPENDIX TABLE. A COMPARISON OF CBO ESTIMATING FACTORS AND DoD DATA

	DoD Experience			CBO Assumptions		
	1984	1985	1986	All Agencies a/	DoD	Non-DoD
Average Percent Savings for Activities Converting b/	41	38	38	35	36	33
Average Percent Savings for In-House Management Improvement b/	22	20	23	20	20	20

SOURCE: Congressional Budget Office and Department of Defense.

NOTE: Information on DoD experience derived from agency information as reported, without CBO adjustments.

a. Figures included under all agencies represent a weighted average that reflects the assumed number of reviews DoD and non-DoD agencies will perform.

b. Average savings are expressed as a percent of in-house costs before contracting out or management improvements.

Moreover, should contracting out result in layoffs, affected workers may be eligible for severance pay and other benefits that increase costs. 2/

The conservative CBO factors also reflect consideration of two phenomena that will affect the potential savings of future A-76 activity but that are not accounted for in DoD cost comparison data--unanticipated cost increases after conversion to contract and federal retirement reform. Technical adjustments by CBO for these two phenomena would reduce average dollar savings available from A-76 reviews governmentwide by about 4 percent.

Unanticipated Cost Increases

Actual savings realized from shifting activities to the private sector may be less than estimated if contracting out results in certain costs not anticipated in cost comparisons. Disputes over work requirements, for example, can lead to claims against the government. Contractors may also go out of business or fail to perform well, necessitating costly procedures to recompete contracts. Moreover, during transition, the work may be temporarily disrupted, increasing costs and reducing savings.

The allowance CBO made for cost increases reflects information from a 1986 DoD study that compared actual savings from contracting out with savings estimates contained in cost comparisons. 3/ The study covered 131 cost competitions won by contractors on the basis of comparisons completed between October 1, 1983 and October 1, 1984. After at least one full year of operation under contract, actual savings amounted to about 96 percent of the level estimated in cost comparisons.

Federal Retirement Reform

DoD cost comparison data available to CBO predates recent civilian retirement reform, which establishes a new retirement system for employees hired after December 1983. The reform will most likely lower the

---

2. CBO assumes almost all jobs could be abolished under A-76 without layoffs by not filling jobs vacated as a result of quits, retirements, and other normal separations. Even under the most aggressive CBO option, full-time jobs freed up would amount to less than 15 percent of the full-time jobs vacated as a result of routine separations. Nevertheless, when A-76 affects employees with specialized skills or activities engaging large numbers of jobs, avoiding some layoffs may be difficult--especially among nondefense agencies where employment has been tight.

3. Department of Defense, *Report to the Congress: The Department of Defense Commercial Activities Program* (April 1986), p. 3.

estimated federal cost of activities covered by future A-76 reviews by about 2.0 percent, thus reducing the savings potential of the A-76 program.

The new retirement system consists of three parts: Social Security; a basic defined benefit plan that ties pensions to years of service and earnings; and a voluntary tax-deferred thrift plan with matching employer contributions. According to OPM estimates, the new retirement system has a full cost to the government of about 24 percent of pay (repesenting, for new employees as a group, the accrual cost of the defined benefit plan, the government's contributions to Social Security, and the cost of the thrift plan). This amount can be compared with an accrual cost for Civil Service Retirement of 27.9 percent of pay--the rate formerly used in preparing cost comparisons at DoD. In considering the impact of retirement reform on conversions and savings under A-76, CBO assumes that contracting out and management improvements would have the end effect of reducing federal requirements for recruiting new workers, all of whom would have been covered by the new plan.

For DoD, CBO's technical adjustments reducing savings to reflect retirement reform are offset by adjustments to reflect additional savings associated with reductions in requirements for military personnel. At DoD, uniformed military personnel are sometimes used to support commercial activity. Contracting out and management improvement can free up military positions, potentially reducing recruitment needs in other areas. In fact, DoD gives priority to freeing up military positions when conducting A-76 reviews. Savings from reducing military positions, on average, could exceed the savings from reducing equivalent civilian jobs because of higher retirement costs. These additional savings, however, are not considered in DoD's cost comparison estimates. 4/ The accrual cost for military retirement under the Military Retirement Reform Act of 1986 (P.L. 99-348), together with the government's share of costs for Social Security, is estimated at 48.1 percent of payroll. CBO calculations assume that about 20 percent of the jobs reviewed at DoD through 1992 will involve military personnel.

---

4. DoD cost comparison data and CBO estimates do not incorporate possible additional savings for freeing up resources associated with relatively high military pay. There is no detailed data for calculating such effects. An unpublished 1987 CBO analysis, however, suggests that after income taxes, pay for selected military positions (including allowances for substistance and housing) stands around 5 percent above commonly compared civilian grades. If such a pattern holds for jobs covered by future A-76 reviews, CBO estimates of extra savings associated with military positions are conservative.

CONVERSION TO CONTRACT

According to data reported by DoD, conversions to contract increased from 53 percent of total in 1984 to 75 percent of total in 1986. These percentages, however, somewhat overstate conversions because data from which they are derived do not cover activities for which agencies received no bids. CBO's estimates assume a level conversion rate of 65 percent through 1992. The lower CBO rate considers that certain activities, representing about 10 percent of total, will not convert because agencies will receive no bids. CBO assumed a discontinuation in the growth of conversions to reflect revisions in cost comparison guidelines which, consistent with statutory provisions contained in the Retirement Reform Act, somewhat understate retirement costs and could therefore limit future shifts to contractor performance. Current guidelines require agencies to use an average cost for retirement set at 21.7 percent of pay. This factor excludes the cost of the new thrift savings plan and Social Security benefits. Revised guidelines also require that the contractor's costs exclude costs for Social Security and any thrift plan offered. It is unlikely, however, that private-sector providers of commercial services would offer thrift or other pension plans to their workers.

CONGRESSIONAL BUDGET OFFICE
Second and D Streets, S.W.
Washington, D.C. 20515

FIRST-CLASS MAIL
POSTAGE & FEES PAID
C.B.O.
PERMIT No. G-70

OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE, $300